23

No. 91-615

IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

ALLIED-SIGNAL INC.,
Petitioner,
v.
DIRECTOR, DIVISION OF TAXATION,
Respondent.

On Writ of Certiorari to the Supreme Court of New Jersey

BRIEF FOR BEATRICE COMPANY, THE COCA-COLA COMPANY, FORD MOTOR COMPANY, INTERNATIONAL BUSINESS MACHINES CORPORATION, INTERNATIONAL PAPER COMPANY, LOEWS CORPORATION, MOBIL OIL CORPORATION, AND W. R. GRACE & CO. AS AMICI CURIAE IN SUPPORT OF PETITIONER

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TABLE OF CONTENTS

TABLE OF CONTENTS—Continued

TABLE OF AUTHORITIES

CASES | Page

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

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INTEREST OF THE AMICI CURIAE

The amici curiae are multijurisdictional corporations that do business in, and are subject to taxation by, many states. Each receives various forms of investment income derived from its ownership of intangible property—including income from dividends, royalties, interest, and

capital gains. The amici therefore have a strong interest in the constitutional principles governing state taxation of intangible and other forms of income earned by multistate businesses. A decision overruling *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982), and *F.W. Woolworth Co. v. Taxation & Revenue Department*, 458 U.S. 344 (1982), would substantially alter those principles and would significantly affect both the tax liabilities of the amici and the environment in which they conduct their business.

Counsel for the parties have consented to the filing of this brief in letters filed with the Clerk of the Court.

SUMMARY OF ARGUMENT

I. A. *ASARCO* and *Woolworth* are an integral part of a longstanding and coherent constitutional structure for the taxation of multistate corporations. A state may tax income only to the extent that it provides benefits and protection to the activities that generate the income. For a functionally integrated enterprise operating in different jurisdictions, states comport with that basic territorial limitation by accumulating all the income of the enterprise and taxing an apportioned share fairly reflecting the enterprise's in-state activities. But where a company earns income through a non-unitary "discrete business enterprise," a state that has no connection with the activities of that separate enterprise has no authority to tax the income it generates; its connection with the company alone is not enough. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439-40 (1980). This "unitary-business principle" is the "linchpin" of the apportionment system. *Id.* at 439.

Mobil, *ASARCO*, and *Woolworth* faithfully apply the unitary business principle to the taxation of intangible income. Dividends are apportionable only if the payor's income-earning activities outside the state are integrally related to the recipient's business activities inside the

state. Overruling these cases would create major dislocations in settled law and yield an inferior system fraught with difficulties.

B. 1. Including in the apportionable base intangible income arising from non-unitary economic activity would add vast sums that bear no relation to the traditional operational apportionment factors—payroll, property, and sales. Fair apportionment of such non-operational income would require major readjustment of existing formulas. States would likely adopt conflicting approaches tailored to maximize their own tax revenues from out-of-state taxpayers, with the practical consequence that multistate businesses, unlike purely local businesses, would be subject to taxation on more than 100% of their income. While the Court has said that the Commerce Clause tolerates *some* risk of multiple taxation from differing state apportionment formulas, the risk may be greatly magnified if significant new sums of passive intangible income are added to the apportionable base. At a minimum, the courts are likely to become embroiled in constitutional evaluation of redesigned apportionment formulas.

2. Abandoning the unitary business principle for intangible income necessarily entails jettisoning that principle for ordinary operational income as well. Under present law, where a company conducts two discrete businesses in different states through unincorporated divisions, each state can tax only the business with which it has a connection. But that rule is untenable if a state can tax dividend income received from a non-unitary subsidiary, because that would create a senseless distinction based on corporate form that has nothing to do with the rationale for the state's exercise of its taxing power. Thus, the logical consequence of New Jersey's argument is completely to eliminate the "linchpin" unitary business principle from the state taxation structure.

3. Overruling *ASARCO* and *Woolworth* would have the effect of substantially restricting state taxing au-

tonomy. Because of Commerce Clause constraints, *permitting* states to tax a company's income earned from its discrete, non-unitary operations requires *prohibiting* other states from fully taxing those discrete enterprises that operate within their borders. Two incompatible theories of taxation cannot coexist when one allows a state to tax income in full while the other permits a different state to tax an apportioned share of the same income. That situation would inevitably yield multiple taxation in violation of the Commerce Clause. *See Mobil*, 445 U.S. at 445-46; *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952).

This principle is fully applicable here. If New Jersey can invoke a common ownership theory to tax an apportioned share of the income from a business that operates discrete divisions in other states, without regard to whether the underlying economic activities are functionally related, it follows that other states will have to tax under the same theory as New Jersey. They would no longer be free to tax a discrete business by itself, but would have to limit themselves to an apportioned share of its income, taking into account other non-unitary businesses under common ownership. This change in the law would directly harm states in which relatively profitable discrete businesses operate. It would also reduce the rationality of the system by drawing tax revenues away from the states where the value being taxed was earned.

4. Considerations of *stare decisis* militate strongly against overruling *ASARCO* and *Woolworth*. Companies have organized their affairs, and states have drafted their statutes, with heavy reliance on the existing unitary business framework. Abandoning that principle would require legislatures in dozens of states to reconfigure their schemes for taxing the income of multistate taxpayers. Even if some change is needed, Congress's ability to study problems and fine-tune solutions makes it far better equipped than the judiciary to tackle the essentially legislative task of constructing a new system of multistate

taxation. To the extent the nexus limitations imposed by current law rest on the Commerce Clause, it is clear that Congress can intervene. Even if those restrictions are an element of due process, Congress may well have authority to legislate because Fourteenth Amendment territorial limitations apply only to the states and are not "designed to forbid action altogether by any power or combination of powers in our governmental system." *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 434-35 (1946).

II. If the Court were to overrule *ASARCO* and *Woolworth*, this would be a powerful case for prospectivity under the traditional analysis of *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971). The change in the law would overturn settled expectations, and retroactive effect would thwart, not promote, underlying constitutional policies. Retroactivity would also create a substantial risk of multiple taxation. Companies suddenly subjected to new taxation of intangible income on an apportioned basis might be unable, because of differing statutes of limitation, to obtain a refund from a state that had fully taxed that income on an allocation theory. The converse situation could unfairly harm states.

ARGUMENT

I. *ASARCO* AND *WOOLWORTH* SHOULD NOT BE OVERRULED

A. *ASARCO* and *Woolworth* Are Solidly Grounded in Long-Established Principles of State Tax Jurisprudence

In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980), this Court distilled from numerous prior decisions a straightforward principle now considered axiomatic: "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." The Court there permitted a non-domiciliary state to tax an apportioned share of Mobil's dividend income because the payor's out-of-state activities were integrally related to Mobil's in-state activities. The Court recognized, however, that the result might be different "[w]here the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, . . . because there would be no underlying unitary business." *Id.* at 442. That was the situation in *ASARCO* and *Woolworth*, where the Court held, true to its statement in *Mobil*, that a non-domiciliary state may not apportion dividends, interest, and capital gains income from investments in non-unitary subsidiaries.

New Jersey has now invited the Court to repudiate the previously settled unitary business principle, to overrule *ASARCO* and *Woolworth*, and to substitute a rule under which a state may tax an apportioned share of all income (or at least all investment income) regardless of whether the economic activities generating that income have any connection at all to the taxpayer's in-state business activities. But the unitary business principle derives inexorably from fundamental constitutional limitations on state taxing power and cannot casually be tossed aside. Abandoning that principle would require dismantling decades of this Court's state tax jurisprudence, drastically reallocating state tax revenues, and disturbing the settled ex-

pectations on which multistate businesses have long relied in structuring themselves.

1. *The Unitary Business Principle Derives from Due Process and Commerce Clause Prohibitions Against Extraterritorial Taxation*

The unitary business principle's analytical wellspring is this fundamental precept: "Under both the Due Process and the Commerce Clauses of the Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.'" *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983) (quoting *ASARCO*, 458 U.S. at 315). A state is entitled to tax only to the extent that it provides "protection, opportunity and benefits . . . for which it can ask return." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940). Income generated by out-of-state economic activities, if unconnected to any in-state activities, has no relationship to the benefits provided by the state and therefore lies beyond its permissible reach.

The rule is not unique to state taxing authority. The Court has long held under the Commerce Clause that a state "has no power to project its legislation into" other states by effectively regulating conduct that occurs there. *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 521 (1935) (milk price regulation). A statute with such "extraterritorial effects," even if "addressed" only to in-state conduct, is invalid if "the 'practical effect' of the law is to control [conduct] in other States." *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 476 U.S. 573, 580-83 (1986) (liquor price affirmation statute).

While a state cannot lawfully control what is *outside* its borders, it has ample authority to tax or regulate what is *inside* its borders. And when something is partly within and partly without, the state naturally has room to determine reasonably the portion properly within its jurisdictional reach. Thus, in the context of income taxa-

tion, where a functionally integrated enterprise conducts its income-generating activities in several different jurisdictions, a state may calculate the "locally taxable income" by the apportionment method—accumulating the income of the multistate enterprise and apportioning to itself a share of the total based on a fair assessment of the state's relative contribution to the enterprise's success. *Container*, 463 U.S. at 164, 165. Because "[t]he net income of an organic, unitary business . . . is indivisible" (*ASARCO*, 458 U.S. at 333 n.1 (O'Connor, J., dissenting)), apportionment is considered a more accurate mechanism than separate geographical accounting for determining where the income of the business is truly earned and therefore the extent to which various states contribute to the income. *See, e.g., Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 218 (1980); *Butler Bros. v. McColgan*, 315 U.S. 501, 506-09 (1942); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282 (1924).

This unitary business principle, however, permits a state to include in the apportionable tax base income from out-of-state activities only if those activities have contributed—either operationally or through the creation of economies of scale or similar economic benefits—to "a unitary stream of income." *Exxon*, 447 U.S. at 226. Where the in-state and out-of-state activities are "discrete business enterprise[s]" (*Mobil*, 445 U.S. at 439), the rationale for formula apportionment breaks down because the income does not make a logically indivisible contribution to the profitability of a single business. The out-of-state income is not relevant to determining "the net profits earned within the State." *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120 (1920).

This fundamental distinction has its source in the century-old "unit rule" for apportioning state property, capital stock, and other taxes imposed on interstate railroads, express and telegraph companies, and similar enterprises. *See, e.g., State Railroad Tax Cases*, 92 U.S. 575, 608 (1875). The rule provides that, where a "unity

of use and management" connects the multistate activities of an enterprise, it may be taxed as a unit—even when "it may not be a physical unity." *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 222 (1897). But it has always been clear that "something more than a mere unity of ownership" is required in order to justify apportionment. *Id.* Out-of-state income is includable in the apportionment base only where it "can be seen in some plain and fairly intelligible way that it adds to the value of the [property] and the rights exercised in the State"; otherwise, apportionment would "open to taxation what is not within the State." *Wallace v. Hines*, 253 U.S. 66, 69 (1920).

2. *The Court's Treatment of Intangible Income in* **Mobil, ASARCO,** *and* **Woolworth** *Follows Inexorably from the Unitary Business Principle*

States have long used apportionment methods to tax multistate *business* income. But most *non-business* income, "such as rentals and capital gains from real and tangible personal property, dividends and interest from investments, royalties from patents or copyrights, and income from personal services," traditionally has been "thought to be specifically allocable to a particular activity rather than to grow out of the general business of the taxpayer." *Developments in the Law—Federal Limitations on State Taxation of Interstate Business*, 75 Harv. L. Rev. 953, 1010-11 (1962). Non-business income therefore has been taxed by allocating it to a particular jurisdiction. *Id.* For example, income from rents and royalties is allocated to the state where the underlying property is situated. *See* J. Hellerstein & W. Hellerstein, *State and Local Taxation* 399, 490-91 (4th ed. 1978). Income from intangible property is allocated to the taxpayer's commercial domicile (*e.g.*, interest and dividend income) or to the state in which the intangible is used (*e.g.*, income from patents and copyrights). *See* Uniform Division of Income for Tax Purposes Act ("UDITPA") §§ 7, 8, 7A U.L.A. 331 (1985).

In *Mobil,* the Court held that the traditional allocation approach to intangible income must bend in the face of the unitary business principle. The Court explained that, "so long as the intrastate and extrastate activities" that gave rise to the income "formed part of a single unitary business," there was no justification for excepting dividend income from the "general principle of apportionability" applicable to operating income. 445 U.S. at 437, 438. The Court emphasized, however, that "[o]ne must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability." *Id.* at 440. Thus, the inquiry is whether the "operations of [the taxpayer's] subsidiaries and affiliates are distinct in any business or economic sense from its [business] activities in [the taxing state]" or whether the "dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise." *Id.* at 439, 440.

In *ASARCO* and *Woolworth,* the Court applied the legal principles synthesized in *Mobil* but ruled that the facts did not demonstrate a unitary business. 458 U.S. at 319. In *ASARCO,* the Court concluded that one of the dividend payors was "insufficiently connected" to the taxpayer's in-state activities and that the other dividend payors were "operate[d] entirely independently of" the taxpayer. *Id.* at 322, 323. In *Woolworth,* the Court found that "there [was] little or no integration of the business activities or centralization of management" linking the out-of-state subsidiaries with the taxpayer. 458 U.S. at 369.

While there is room to debate the Court's application of the legal principles to the facts of those cases, the legal principles themselves are rooted in the traditional unitary business concept. Indeed, the taxing states in those cases, like New Jersey here, had to acknowledge that they could not prevail unless the Court agreed to "expand the concept" so that "corporate *purpose*" or the economic bene-

fit of common ownership alone would justify apportionment. 458 U.S. at 325, 326 (emphasis in original); 458 U.S. at 363. But that approach, as the Court rightfully recognized, would tear the unitary business principle from its moorings in the prohibition against extraterritorial taxation. As the Court subsequently reiterated in *Container*, the essential focus remains on the extent to which the underlying income-generating activities are connected with the business conducted in the taxing state; the "mere flow of funds arising out of a passive investment or a distinct business operation" is insufficient to make "formula apportionment a reasonable method of taxation." 463 U.S. at 166.

B. Abandoning the Unitary Business Principle Would Pose Significant Constitutional and Practical Difficulties

In an area of the law where business planning puts a premium on certainty, the principles underlying *ASARCO* and *Woolworth* have become part of the legal landscape within which multistate corporations and state taxing authorities operate. With UDITPA providing guidance, the unitary business principle is now woven into the fabric of state tax statutes; abandoning that principle will require almost every state to take legislative action to revamp its tax laws. The present structure has proven to be workable, and it should be retained unless there exists a clearly superior substitute. That is not the case. Indeed, the proposal for replacing *ASARCO* and *Woolworth* is demonstrably *inferior*. It would raise a host of new issues for litigation and would ultimately create intractable difficulties in achieving a fair and rational system for taxation of multistate corporations.

1. *Apportionment of Intangible Income from Non-Unitary Investment Would Require Wholesale Revisions and Judicial Reassessments of State Apportionment Formulas*

To pass constitutional muster, "the factor or factors used in [an] apportionment formula must actually reflect a reasonable sense of how income is generated." *Container*, 463 U.S. at 168. Most states, including New Jersey, apportion income in accordance with the familiar three-factor formula, representing the unitary business's in-state ratios of payroll, property, and sales. That apportionment mechanism has been approved because "payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." *Id.* at 183.

The three-factor formula and its variations, however, reflect *operational* activities of a business and are designed to apportion *operational* income. That is so because the apportionable income base traditionally has been composed of income arising from transactions and activities conducted in the regular course of an active trade or business. *See, e.g.*, UDITPA §§ 1(a), (4). If the apportionable income base were significantly expanded to include large amounts of passive investment income from a taxpayer's holdings in discrete business enterprises, the traditional apportionment formulas would require concomitant adjustments to reflect reasonably the way such *non*-operational intangible income is generated. As Justice Stevens observed in his dissenting opinion in *Mobil*, "it is improper simply to lump huge quantities of investment income that have no special connection with the taxpayer's operations in the taxing State into the tax base and to apportion it on the basis of factors that are used to allocate operating income." 445 U.S. at 459. *See also Container*, 463 U.S. at 168 n.5.

Permitting apportionment of non-unitary passive investment income will therefore impose on states the obli-

gation to restructure their existing formulas. There is every reason to anticipate that they will adopt a crazy-quilt of conflicting solutions because there is no generally accepted method for apportioning such diverse kinds of intangible income as dividends, capital gains, and interest. The differences that emerge will not be random; rather, they may well arise from conscious decisions by individual states to maximize their own revenues from out-of-state taxpayers. The practical consequence is that companies operating in several states, unlike companies operating exclusively within one state, will be exposed to taxation on more than 100% of their income.

In approving Iowa's use of a single-factor sales formula to apportion operational income, the Court determined that the Commerce Clause tolerates, as the price of federalism, "some risk of duplicative taxation" occasioned by inconsistent apportionment mechanisms. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 278 (1978). But if states are allowed to include in the apportionable tax base intangible income received from a non-unitary source, that risk will be greatly magnified—both because the fresh proliferation of more complex apportionment formulas will increase inconsistencies and because much more income will be funneled into the apportionable base. At some point, the multiple taxation that would inevitably result would so seriously threaten core Commerce Clause values—by imposing on interstate businesses duplicative tax liabilities from which intrastate enterprises are immune—that the limits of constitutional tolerance would surely be tested. At a minimum, the courts would almost certainly become embroiled in a whole new species of state tax litigation addressing the reformulated apportionment mechanisms and perhaps calling for heightened scrutiny of differing formulas to minimize the resulting interference with free interstate trade.

2. *Rejecting* ASARCO *and* Woolworth's *Treatment of Intangible Income Necessarily Comprehends Rejecting Unitary Taxation Principles for Operational Income As Well*

The problems with New Jersey's position go well beyond the difficulties it would pose in dealing with intangible income. This is so because the logical consequence of jettisoning the unitary/non-unitary distinction for intangible income is similarly abandoning the distinction for ordinary, operational income. Otherwise, the taxing power of states over income generated by out-of-state economic activity, and the attendant division of tax revenues among the states, will vary substantially, but irrationally, depending on the corporate form chosen by the parent.

This problem is best illustrated by way of a simple example, similar to the one considered by the Court at oral argument in this case. Suppose a company, resident in Delaware, operates a beauty parlor business in New Jersey. It also operates a parking lot business in California. The latter is a "discrete business enterprise" (*Exxon*, 447 U.S. at 224; *Mobil*, 445 U.S. at 439) having nothing to do with the activities of the beauty parlor business.

If the businesses were structured as a parent corporation directly operating beauty parlors and also owning a California parking lot subsidiary, income from the parking lots would flow to the parent in the form of dividends. Contrary to *ASARCO*, New Jersey argues that it should be accorded the right to tax an apportioned share of those dividends as intangible income to the parent, with whom New Jersey has nexus because of the parent's beauty parlor business.

If we suppose instead that the businesses operate not through separate corporations, but rather through two divisions of the single corporation headquartered in Delaware, there would be no dividends or other intangible income. The parking lot business would earn the same income, but it would flow directly into the coffers of the

single corporation. Could New Jersey tax an apportioned share of that income?

The answer under current law is clearly no. That was precisely the issue presented in *Exxon*. The Court rejected Exxon's contention that its functional departments were "discrete business enterprises," concluding instead that they were all part of one "unitary business." 447 U.S. at 224. Based on that conclusion, it upheld Wisconsin's right to tax income from departments that did not do business in the state. But the case obviously began with the agreed legal premise that Wisconsin could *not* tax such income if the departments were not part of Exxon's unitary business. Otherwise, it would have been unnecessary to make the factual inquiry into unitariness. *See also, e.g., Butler Bros. v. McColgan*, 315 U.S. 501, 506-09 (1942); *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 222 (1897).

But this settled result cannot logically coexist with New Jersey's proposed overruling of *ASARCO*. It is irrational for New Jersey's power to tax income from the parking lot business to vary depending upon whether the company operates the business through a division or a separate corporate entity that pays dividends. *See United States v. Goodyear Tire & Rubber Co.*, 110 S. Ct. 462, 467-68 (1989) (foreign tax credit rules tailored to eliminate unnecessary differences in tax treatment that depend on whether company operates through subsidiary or division). In either case, the economic activity that generates the income is the same. And the difference in corporate form has no apparent relationship to any justification for the exercise of the state's taxing jurisdiction.

In the state tax context involved here, this Court has already definitively rejected such a distinction in treatment based on corporate form. The Court observed in *Mobil* that "[o]ne must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability." 445 U.S. at 440. Whether

run directly or through a subsidiary, the underlying activity is operating parking lots in California, and New Jersey's power to apportion income from that business should be the same in both cases. The Court held to that effect in *Mobil*: "Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives." 445 U.S. at 441.

This principle is equally applicable when the economic realities are that the business in question is non-unitary. If New Jersey's connection to the parent corporation gives it the power to tax non-unitary parking lot income when returned to a parent as a dividend, New Jersey should be able to tax the same parking lot income when it is earned directly by the parent. There is surely no constitutional justification for drawing any distinction. The nexus relied upon by New Jersey is the same in both instances—namely, the fact that the beauty parlor business operates in New Jersey.

In sum, New Jersey's argument that it can tax all intangible income of a company that does business there, whatever the source of the income, necessarily extends to the company's business income. Indeed, New Jersey has no doubt on this score. Counsel for the state explicitly acknowledged at oral argument that its approach would essentially eliminate the unitary business concept (Tr. 31-33, 39-40); all of a corporation's income would be regarded as "unitary" by definition. And New Jersey's income tax statute draws no distinction between tangible and intangible income. *See* N.J. Stat. Ann. §§ 54:10A-4 (k), 54:10A-5(c). New Jersey thus proposes to scrap—for both tangible and intangible income—what this Court has repeatedly described as "[t]he 'linchpin of apportionability' for state income taxation." *Exxon*, 447 U.S. at 223 (quoting *Mobil*, 445 U.S. at 439). Removing this "linchpin" will require the painstaking construction of a new system of apportionability, one that will be fraught

with more problems and ultimately will be less fair than the longstanding unitary business system.

3. *Abandoning Unitary Taxation Will Create Obstacles to a State's Ability to Tax Income Earned Within Its Borders*

New Jersey's request for authority to tax income earned by a non-unitary business inevitably carries with it a restriction on the authority of other states to tax income under a traditional, unitary business approach. Any new taxing power that the Court gives to New Jersey must be taken away from some other state. Otherwise, the new system that would emerge could not survive Commerce Clause scrutiny because it would yield inevitable multiple taxation of multistate corporations.

This Court has recognized for many years that permitting property taxation on the basis of apportionment is incompatible, as a matter of constitutional law, with full taxation by the state of domicile. In *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952), Ohio claimed the right to collect property tax on the full value of barges owned by an Ohio company. The Court rejected that claim because other states where the barges operated were empowered to tax the value of the barges on an apportioned basis. The Court explained (*id.* at 384-85): "The rule which permits taxation by two or more states on an apportionment basis precludes taxation of all of the property by the state of the domicile. . . . Otherwise there would be multiple taxation of interstate operations." *See also Braniff Airways, Inc. v. Nebraska State Bd. of Equalization & Assessment*, 347 U.S. 590, 601 (1954). In *Central Railroad Co. v. Pennsylvania*, 370 U.S. 607, 614 (1962), the Court reemphasized that the possibility of apportioned property taxation by other states "would render unconstitutional any domiciliary ad valorem tax at full value." *Id.*

The constitutional infirmity inherent in permitting taxation under both apportionment and allocation theories

formed the basis for this Court's holding in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). The Court there held that a state could not impose an apportioned property tax on foreign-owned instrumentalities of international commerce because that would pose an unacceptable "risk of international multiple taxation." *Id.* at 451-52. The Court explained the governing principle as follows (*id.* at 447): "The corollary of the apportionment principle, of course, is that no jurisdiction may tax the instrumentality in full. . . . The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies." Because the Court was not in a position to prevent the foreign country of domicile from taxing the full value of the property on an allocation theory, it held that the Commerce Clause prohibits a state from taxing a portion of that value on an apportionment theory. *Id.* at 447-48, 451-52.

The Commerce Clause barrier to allowing different states to use incompatible theories of taxing jurisdiction is equally present in the context of state income taxation, and the Court so held in *Mobil. See* 445 U.S. at 442-46. Mobil objected on multiple taxation grounds to the Court's holding that Vermont could tax a portion of the dividends received by a New York corporation so long as the dividend payor was part of the unitary business of the company doing business in Vermont. Mobil argued that this would violate the Commerce Clause because the domiciliary state was already permitted under established law to allocate 100% of those dividends to itself for unapportioned taxation (although in fact New York had not elected to tax the dividends).

This Court agreed with the basic principle of Mobil's multiple taxation argument—namely, that two distinct income taxation systems cannot be permitted to coexist if they provide for taxation of more than 100% of the taxpayer's income. "Taxation by apportionment and tax-

ation by allocation to a single situs are theoretically incommensurate, and if the latter method is constitutionally preferred, a tax based on the former cannot be sustained." 445 U.S. at 444-45. The Court rejected Mobil's conclusion only because it believed that the conflict should be resolved by having New York's ability to tax 100% of dividend income yield in the face of Vermont's right to tax an apportioned share of the dividends. The Court ruled that, although the state of domicile is authorized "to lay *some* tax on [Mobil's] dividend income . . . there is no reason in theory why that power should be exclusive when the dividends reflect income from a unitary business, part of which is conducted in other States." *Id.* at 445-46 (emphasis added).

In *Mobil*, the Commerce Clause prohibition on incompatible taxation theories affected only the unique taxing authority historically accorded to the domiciliary state over dividend income—and then only to the extent dividends are received from a unitary subsidiary. But if New Jersey's position here is upheld, the longstanding authority of all states to tax economic activity occurring within their borders will be undermined. Just as apportionment and allocation are "incommensurate" theories of taxation, so too are full taxation on a discrete enterprise theory and New Jersey's approach of apportioned taxation on a common ownership theory without regard to whether businesses are unitary. Under the present system, the state in which a discrete business enterprise is located can fully tax the income from that business, without regard to whether the enterprise shares common ownership or affiliation with some other discrete businesses located in other states. But New Jersey now claims the right to tax a portion of the income from a discrete business enterprise operating outside New Jersey—on the basis of New Jersey's connection to an affiliated (but nonunitary) enterprise that does do business in New Jersey. Upholding that claim means that double taxation will inevitably result unless the first state in which the dis-

crete business enterprise is located is required also to apportion its tax.

This serious implication of New Jersey's argument is well illustrated by the example considered by the Court at oral argument and discussed earlier—that is, where a company operates through unincorporated divisions a beauty parlor business in New Jersey and a parking lot business exclusively in California. Under current law, California would tax the discrete enterprise that operates there; because the parking lot business operates entirely in one state, California would tax 100% of the income. But if New Jersey is upheld in its claim to tax an apportioned share of the parking lot income, California cannot be permitted to continue its practice of taxing the parking lot business in full as a discrete enterprise. As this Court made clear in *Mobil*, apportioned taxation by New Jersey coupled with 100% taxation by California of the same income runs afoul of the Commerce Clause. The Court would have to exercise "its ability to enforce full apportionment by all potential taxing bodies" (*Japan Line*, 441 U.S. at 447), not just by New Jersey. Thus, as counsel for the state acknowledged at oral argument (Tr. 43-44), the inevitable consequence of New Jersey's argument that it be *permitted* to tax non-unitary business income is that other states must be *prohibited* from taxing in full the income of businesses operating exclusively within their own state.

This departure from well settled state tax law would be a step backwards from the present system in terms of fairness and rationality because it would undermine the longstanding guiding principle that income should be taxed by the state in which value was earned. In expanding the power of states to tax non-unitary business income, New Jersey's proposal would correspondingly diminish the power of states to tax discrete businesses without apportionment, thereby redistributing tax revenues away from the states that contributed their services and protections to the generation of the income. If the park-

ing lot business were profitable and the beauty parlor business were not, the change would directly reduce California's tax revenue, in effect forcing California to cede to New Jersey some of its income tax base.

The irrationality and multiple taxation potential of New Jersey's proposal is exacerbated when non-business income is thrown into the mix. Suppose in our example that, in addition to the beauty parlor and parking lot businesses, the company conducted investment activities in its home state of Delaware. This situation would be uncomplicated under current law. California would be permitted to tax 100% of the parking lot income, New Jersey would be permitted to tax 100% of the beauty parlor income, and Delaware would be permitted to tax 100% of the investment income.

Adopting New Jersey's proposal, however, would introduce substantial confusion. New Jersey presumably would seek to tax an apportioned share of all the income of the corporation, including the parking lot income and the investment income (perhaps making some factor adjustment to account for the investment activities). Delaware might still seek to tax 100% of the investment income, though under *Mobil* it presumably would be constrained by New Jersey's taxation on an apportionment theory. California also would have a claim to some portion of the investment income under New Jersey's theory that the non-business income of a company can be taxed by any state in which that company does business, no matter how discrete its operations. Indeed, New Jersey's theory presumably would allow Delaware, on the basis of the investment activity, to tax a portion of the income from the New Jersey and California operations. It would be imprudent, at best, to jettison 70 years of settled law for the purpose of introducing this kind of chaos.

Finally, abandonment of the unitary business approach could harm the public fisc by opening the door for corporate tax planners to take steps that would result in

reduction of the aggregate state tax base. If a state is prohibited from taxing on a traditional unitary basis and instead must apportion on the basis of all the taxpayer's operations, including discrete enterprises operating only in other states, the state's tax base necessarily will be affected by all changes in a company's business, even when those changes bear no relation to the business activity that the state is trying to tax. This circumstance could tempt companies to invest in businesses that operate in states that have no, or relatively light, corporate income tax.

For example, if Nevada has no corporate income tax, the company operating beauty parlors in New Jersey and parking lots in California might purchase a supermarket chain in Nevada. The new investment would bring substantial tax benefits because a supermarket would have relatively significant apportionment factors, such as a high sales volume, coupled with relatively low net income. Incorporating those factors into the company's apportionment formula would draw income from the beauty parlor and parking lot businesses into Nevada for taxation. The company would then have succeeded in reducing its total state tax bill by reducing the amount of income available for taxation by California and New Jersey and attributing that income to Nevada, where no state income tax is imposed.

4. *Any Significant Departure from the Unitary Business Principle Should Come from Congress, Not from This Court*

Even if this Court were to agree with New Jersey as a matter of first principles that intangible income should be taxable without regard to the unitary business limitation, it would be inappropriate to overturn decades of established law to implement that conclusion. "Considerations in favor of *stare decisis* are at their acme in cases involving property and contract rights, where reliance interests are involved." *Payne v. Tennessee*, 111 S. Ct.

2597, 2610 (1991). *See also National Bank v. Whitney*, 103 U.S. 99, 102 (1880). Taxation is one area where "it is more important that the applicable rule of law be settled than that it be settled right." *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting). That is particularly true in this context where the reliance interests are so strong for both multistate businesses and states.

Businesses have organized their affairs in justified reliance on the Court's established state tax jurisprudence, making decisions such as where to locate their headquarters and whether to acquire other businesses. The states have drafted their statutes to fit into the framework of the present system. Indeed, this Court has noted that the unitary business principle "forms the basis for" UDITPA, which is the product of an effort to achieve uniformity in this difficult area and which has been adopted by about half the states. *Container*, 463 U.S. at 165. The Court should not lightly dash the expectations of these parties, require states to revamp their tax codes, and create substantial "practical dislocation" of the established framework for operating, and taxing, multistate businesses. *Northwest Airlines, Inc. v. Minnesota*, 322 U.S. 292, 300 (1944).

To the extent it is necessary to consider substantial changes in the system for state taxation of multistate corporations, Congress is much better equipped to handle that task than is this Court. Congress has tools at its disposal, such as the hearing process, to study the broad scope of the issue and the full ramifications of any changes. The Court is comparatively hampered in this regard because it must deal with the complex issues on the basis of single cases that come before it for adjudication. *See Northwest Airlines*, 322 U.S. at 299-300; *McCarroll v. Dixie Greyhound Lines, Inc.*, 309 U.S. 176, 189 (1940) (Black, J., dissenting). Unlike this Court, Congress also has the power to fine-tune its changes, through mech-

anisms such as transitional rules, to minimize the adverse impact on reasonable expectations. Congress also can legislate at a level of detail unavailable to the judiciary in order to promote rationality in a new system—for example, by delineating permissible methods of apportionment. *See generally ASARCO,* 458 U.S. at 349-53 (O'Connor, J., dissenting).

There is room for the exercise of congressional authority in this area even though the unitary business principle rests on constitutional foundations. Indeed, the Court explicitly stated in *ASARCO* that it viewed the scope of congressional authority as an open question, denying the dissent's accusation that the majority had "'strip[ped] Congress of the authority' to authorize or regulate state taxation." *See* 458 U.S. at 327 n.23. Chief Justice Burger concurred in reliance "on the Court's express statement that the Court's holdings do not preclude future congressional action in this area." *Id.* at 331.

While the Court has invoked both the Due Process Clause and the Commerce Clause in its decisions, various Justices periodically have questioned whether the Fourteenth Amendment is truly the source of the restrictions on state taxing authority embodied in *ASARCO* and its predecessors. *See ASARCO,* 458 U.S. at 350 n.14 (O'Connor, J., dissenting); *Central Railroad Co. v. Pennsylvania,* 370 U.S. at 618-22 (Black, J., concurring); *Union Refrigerator Transit Co. v. Kentucky,* 199 U.S. 194, 211 (1905) (opinion of Holmes, J.). To the extent those restrictions rest solely on the Commerce Clause, there is no doubt that Congress can legislate to change them. *See, e.g., Western & Southern Life Ins. Co. v. State Board of Equalization,* 451 U.S. 648, 652-53 (1981).

Moreover, even if these restrictions do inevitably reflect due process considerations, that does not necessarily prohibit Congress from taking action. A nexus limitation on state taxation imposed by the Fourteenth Amendment

does not carry with it any analogous Fifth Amendment prohibition on federal action because there are no territorial barriers to federal taxation within the United States. Since the nexus "limits are inapplicable to federal regulation," it has been argued that Congress should "be able to remove them, regardless of whether the theoretical limit on state power stems from the due process clause or from the commerce clause." Cohen, *Congressional Power to Validate Unconstitutional State Laws: A Forgotten Solution to an Old Enigma*, 35 Stan. L. Rev. 387, 401 (1983); *see also* Hartman, *Collection of the Use Tax on Out-of-State Mail-Order Sales*, 39 Vand. L. Rev. 993, 1022-28 (1986).

This argument finds support in *Prudential Insurance Co. v. Benjamin*, 328 U.S. 408 (1946), which upheld Congress's authority to override this Court's Commerce Clause decisions. The Court stated that Congress's authority was limited only by constitutional provisions "designed to forbid action altogether by any power or combination of powers in our governmental system." *Id.* at 434-35. Where there is no constitutional prohibition on Congress's freedom of action, Congress may choose to exercise its authority "alone . . . or in conjunction with coordinated action by the states." *Id.* at 434.

In *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985), Justice O'Connor argued in dissent that the rationale of *Benjamin* extended beyond its Commerce Clause setting. She maintained that a discriminatory state insurance tax could not be struck down as violative of the Equal Protection Clause if it was authorized by the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015. She explained that the federal statute would override the constitutional prohibition on state discrimination against out-of-state business because "any federalism component of equal protection is fully vindicated where Congress has explicitly validated a parochial focus." 470 U.S. at 899 (O'Connor, J., dissenting).

The full Court did not reach this issue in *Metropolitan Life* because the majority did not agree that McCarran-Ferguson authorized states to pass protectionist legislation that would violate equal protection. More recently, however, the Seventh Circuit has reached the same issue of congressional authority in a different context and has explicitly embraced the conclusion suggested by Justice O'Connor. *Milwaukee County Pavers Ass'n v. Fiedler*, 922 F.2d 419, *cert. denied*, 111 S. Ct. 2261 (1991). Analogizing to the Commerce Clause, the court held that Congress could authorize the states to engage in affirmative action programs that would otherwise be constitutionally prohibited so long as Congress itself could have implemented the programs. Congress had merely "enlisted states as its agents." *Id.* at 424.

These authorities suggest that "Congress can consent to state laws where constitutional restrictions bind the states but not Congress" (Cohen, *supra*, at 406), which would include state tax measures that offend nexus requirements embodied in the Fourteenth Amendment. Congress and the states are not "forbidden to cooperate . . . to achieve legislative consequences, particularly in the great fields of regulating commerce and taxation, which, to some extent at least, neither could accomplish in isolated exertion." *Prudential Ins. Co. v. Benjamin*, 328 U.S. at 439.[1]

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[1] In any event, even if Congress cannot override entirely a ruling rooted in the Due Process Clause, its pronouncements should, at minimum, inform this Court's consideration. Under Article I, section 8, Congress is the expert in the area of commercial relations—both interstate and foreign. As a consequence, a congressional judgment concerning the allocation of multistate business income is entitled to considerable deference. As Chief Justice Marshall stated for the Court in *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 401 (1819), "[a]n exposition of the constitution, deliberately established by legislative acts, . . . ought not to be lightly disregarded." *See also Walters v. National Ass'n of Radiation Survivors*, 473 U.S. 305, 318-19 (1985). While the Court might reach one conclusion where it is writing on a blank slate, it might come to a different one where a comprehensive federal enactment forms the backdrop.

II. A DECISION OVERRULING *ASARCO* AND *WOOLWORTH* SHOULD APPLY ONLY PROSPECTIVELY

If the Court decides to abandon the unitary business principle and to overturn *ASARCO* and *Woolworth*, the new rule should apply only prospectively to tax years commencing after the date of the decision. We recognize that the Court is divided over whether it may ever accord purely prospective effect to its rulings. *See James B. Beam Distilling Co. v. Georgia*, 111 S. Ct. 2439 (1991). But unless a majority is prepared to embrace the rule of automatic retroactivity advanced by the concurring Justices in *Beam* (*see id.* at 2449 (Blackmun, J., concurring) and 2450 (Scalia, J., concurring)), this is among the strongest cases imaginable for pure prospectivity under the traditional three-prong test of *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971).

First, a decision repudiating *ASARCO* and *Woolworth* would self-evidently "establish a new principle of law . . . by overruling clear past precedent on which litigants may have relied." 404 U.S. at 106. Far more clearly than in *American Trucking Associations v. Smith*, 110 S. Ct. 2323 (1990)—where the overruled line of authority had already been substantially eroded before it was finally discarded (*see id.* at 2331 (plurality opinion))—an overruling in this case would amount to a sudden and unexpected about-face.

Second, retroactive application of a new rule would not "further"—on the contrary, it would "retard"—the underlying constitutional policies. *Chevron*, 404 U.S. at 107. Certainty in matters of tax law is critical to an efficient national economy. Retrospective abrogation of state taxing limitations would replace certainty with volatility, would unsettle interstate markets, and would disserve Commerce Clause values. Multistate businesses would be forced to weigh the possibility that their projected returns will be reduced by unforeseeable retroactive changes in constitutional tax doctrine. If companies cannot plan their business affairs with confidence in this

Court's authoritative pronouncements concerning the outer boundaries of state taxing authority, they are at least marginally discouraged from engaging in robust interstate trade.

Nor does any policy of the Due Process Clause require retroactivity. If this Court were to conclude that the due process holdings of *ASARCO* and *Woolworth* too narrowly confine the taxing powers of non-domiciliary states, a prospective change would be sufficient to release those constraints and restore to the states whatever additional jurisdictional authority the Court believes they have. Retrospective exercise of such authority would not further any due process principle. The Clause is fully vindicated if the reach of state taxing power is correctly circumscribed; it is wholly neutral concerning whether a state in fact collects taxes to the limit of its powers. If anything, the retroactive imposition of new tax liabilities for past conduct would be abhorrent to traditional due process norms, at least insofar as it "unduly interfer[es] with settled expectations." *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 110 S. Ct. 2238, 2252 n.23 (1990).

Third, retroactive application of a decision overruling *ASARCO* and *Woolworth* would produce "substantial inequitable results." *Chevron*, 404 U.S. at 108. Business taxpayers have structured their operations over many decades in reliance on this Court's unbroken line of constitutional decisions predicating the apportionability of income on the unitary business principle. Nothing in any of the Court's prior decisions would have alerted taxpayers to the possibility of a dramatic change in the applicable rules. When, as in this instance, affected parties "cannot be expected to foresee that a decision of this Court would overturn established precedents, the inequity of unsettling actions taken in reliance on those precedents is apparent." *American Trucking Ass'ns v. Smith*, 110 S. Ct. at 2333 (plurality opinion).

The risk of gross inequity is especially acute in the present context, because retroactive imposition of a new state taxing regime would open the door to multiple taxation. Taxpayers could well find themselves exposed to a wave of new retroactive assessments by non-domiciliary states asserting the power to tax an apportioned share of intangible income that has already been taxed in full by the domiciliary state. Because of differing statutes of limitations, however, the same taxpayers may be foreclosed from seeking refunds from the domiciliary state and could therefore wind up paying multiple state taxes on the same income. The potential competitive dislocations and financial disruptions are inestimable. Conversely, some states may be exposed to a raft of refund claims from domiciliary corporations but may be foreclosed in some cases from issuing new assessments to non-domiciliaries whose prior tax years are closed. The consequent retrospective reallocation of tax dollars among the states and tax liabilities among taxpayers would likely produce a needless flood of new litigation and significantly distort commercial marketplaces with inequitable results for all concerned.

Even if a majority of the Court were to adopt a principle of automatic retroactivity in civil cases, the equitable considerations discussed above should counsel strongly against overuling *ASARCO* and *Woolworth*. As the concurring Justices in *Beam* noted, a rule of automatic retroactivity "forces us to consider the disruption that our new decisional rules cause" and "combines with *stare decisis* to prevent us from altering the law each time the opportunity presents itself." 111 S. Ct. at 2540 (Blackmun, J., concurring). Given the potential in this case for massive economic dislocations if the Court were to " 'make new law' " (*id.* at 2451 (Scalia, J., concurring)), it should be particularly loath to take that drastic step here.

CONCLUSION

The judgment of the Supreme Court of New Jersey should be reversed.

Respectfully submitted,

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